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Comments Requested on Accounting for Insurance Contracts

Most companies that sell or buy insurance are likely to be affected by the FASB's project on insurance risk transfer, and those that might be most affected may want to respond to the FASB's just-published Invitation to Comment.¹ The fundamental question is whether to separately account for the financing and insurance-risk-transfer elements of insurance contracts. The Invitation to Comment also addresses potential definitions and methods for deciding when and how to separate the contracts. The FASB uses the term "bifurcation" to refer to dividing a contract into two components for accounting purposes and the term "deposit" to refer to the financing component.

Requirements to separately account for the insurance and deposit elements of insurance contracts would be a significant change, because most contracts are now accounted for in their entirety as either insurance or a deposit. The Invitation to Comment cites the consequences of the insurance-or-deposit decision and the opportunities to limit the amount of risk transferred and still achieve insurance accounting for the entire contract. It then asks whether required bifurcation would more consistently depict the economics of the arrangements.

The Potential Change	1
Scope of the Invitation to Comment	2
Identifying Contracts to be Bifurcated	2
Bifurcation Methods	3

The project is partly a response to perceived abuses in accounting for certain "finite risk" insurance and reinsurance contracts, allegedly used in some cases to enhance reported financial condition or financial results, rather than to protect against loss.

The Potential Change

Today's insurance-or-deposit determinations depend on whether the contract transfers "significant insurance risk" to the insurance company. The significance of the insurance risk trans-

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¹ FASB Invitation to Comment, Bifurcation of Insurance and Reinsurance Contracts for Financial Reporting, May 26, 2006, available at <http://www.fasb.org>. Invitations to Comment differ from exposure drafts in that they are issued early in a standards project, typically before the Board has deliberated major issues.

ferred is based on the cash flows of the insurance contract. If the contract does not transfer significant insurance risk, it is accounted for entirely as a deposit, akin to a loan. This would be the accounting treatment, for example, if a company pays \$1,000 in annual premiums for up to \$5,000 of coverage for five years, with most of the premium to be refunded if premiums exceed losses incurred, but with additional premium due from the policyholder in the event of losses exceeding the amount of the premiums.

Concerns have been raised about whether adequate guidance is available to apply the insurance-risk-transfer test.² Contracts frequently have features that limit insurance risk, but may not eliminate it. Here are examples:

- Adjustable fees and profit-sharing (leveling) arrangements between the policyholder and insurer,
- Contract termination provisions favorable to the insurer,
- Retrospectively rated premiums determined after the inception of the policy based on incurred losses.
- Premiums that are a substantial percentage of the maximum coverage amount,
- Loss corridors that limit or eliminate the risk of loss for a specified percentage or dollar amount of claims, and
- Dual triggers for payment of a claim, requiring both the occurrence of an insured event and changes in a pre-determined variable.

Under today's accounting, insurance-or-deposit determinations have markedly different income-statement effects, particularly if claim losses are not incurred evenly over the coverage period. Premiums paid under a contract accounted for as insurance are generally charged to expense evenly over the coverage period, with claim losses having no net effect on the insured's income for the insured portion of the loss. If the contract is accounted for as a deposit, however, the premium paid is treated similarly to a loan, with cash flows under the contract accounted for using the interest method and claim losses charged against the insured's earnings in the period they are incurred.

The effect of bifurcation on the income statement would depend on the relative sizes of the insurance and deposit components. However, it would mean that claim losses under the deposit component of the contract would be charged against the insured's earnings in the period they are incurred without the benefit of an insurance recovery.

Scope of the Invitation to Comment

The Invitation to Comment applies equally to insurance and reinsurance contracts for both the buyers and sellers of those contracts. It requests views and comments on these subjects:

- Definitions and descriptions of the terms "insurance contract," "insurance risk," and

"finite" insurance and reinsurance. The definitions play an essential role in the risk-transfer analysis.

- Whether accounting separately for a contract's insurance and non-insurance elements would provide more understandable and decision-useful information to financial-statement users than does the entire-contract approach now applied.
- Whether Statement 113 can be applied by corporate policyholders and insurers to determine whether an insurance contract transfers significant risk.
- An approach to identifying which, if any, contracts should be subject to bifurcation and three possible methods for bifurcation.
- Whether the information needed to bifurcate contracts would be available.
- Whether the FASB should be considering bifurcation of insurance contracts in view of the IASB's ongoing insurance contracts project.

Identifying Contracts to be Bifurcated

The Invitation to Comment asks for views on an approach that applies a series of screens in order to eliminate from consideration those contracts that are either substantially all insurance or all financing, and not candidates for bifurcation. Four screening steps would be applied to the reporting entity's pool of insurance contracts, and a potential fifth step is also illustrated.

²The American Academy of Actuaries, for example, recently formed a group to develop a white paper on technical issues associated with risk-transfer testing under Statement 113 on reinsurance contracts. Guidance for insurance contracts is even more limited, although many have applied the reinsurance guidance by analogy to insurance contracts. FASB Statement No. 113, *Accounting and Reporting for Reinsurance of Short-Duration and Long-Duration Contracts*, December 1992, available at www.fasb.org.



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1. Eliminate contracts that do not meet the definition of an insurance contract.
2. Separate any embedded derivatives from the contract and account for them under Statement 133.³
3. Eliminate contracts that “unequivocally transfer significant insurance risk,” which would be accounted for in their entirety as insurance contracts.
4. Apply Statement 113’s risk transfer tests. Contracts that fail the tests would be accounted for as deposits, as they would be under Statement 113.
5. Either bifurcate the remaining contracts into an insurance and a financing component or evaluate the remaining contracts to identify only those whose economic substance includes a significant financing component for bifurcation. A significant financing component could be indicated by either (a) contract terms that result in premiums paid plus investment earnings on those premiums by the insurer approximating the recoveries expected by the policyholder or (b) terms that provide for significant loss sharing between the policyholder and insurer.

Bifurcation Methods

The FASB identifies three bifurcation methods, but requests suggestions for other methods. The three identified methods are briefly described below.

- The *expected-payout method* focuses on the components of contracts that are likely to produce insignificant variability in cash flows. This is a “dollar-trading” method. The Invitation to Comment uses the term “dollar trading” to mean that a portion of the premium paid is expected to be returned to the policyholder in the form of claim payments and suggests that this portion of the premium could be accounted for as a deposit.
- The *proportional method* measures the degree of risk in a policyholder’s cash flows (a) before insurance and (b) after the effect of the insurance contract. The ratio of (b) to (a) would be the percentage of risk retained by the policyholder and would be used to determine the portion of cash flows that represents the deposit component.
- The *cash flow yield method* treats the cash flows yielding the interest rate on a loan as financing (deposit accounting), with the remaining cash flows accounted for as insurance.

The FASB points out that each of the three methods would have to be tested in order to determine whether it would be operational and whether the bifurcated results would significantly improve financial reporting for insurance contracts.



Comments on the Invitation to Comment are due by August 24, 2006. It is likely that some views will be strongly influenced by what is considered practicable.

The descriptive and summary statements above are not intended to be a substitute for the text of any of the cited documents or any other potential or actual requirements. Those accounting for specific transactions should refer to the texts of the applicable documents that set out GAAP and/or SEC requirements and consult their accounting and legal advisors.

³ FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, June 1998, available at www.fasb.org.